

CHAPTER FIFTEEN

A LOOK AT OTHER DISCOUNTS

Chapter Objective

Identify other specific risks sometimes treated as discounts in a business valuation engagement.

I. INTRODUCTION

While discounts for a lack of marketability and lack of control are the most commonly utilized discounts in business valuations, there are a host of additional gross value adjustments practitioners might encounter in conducting business valuation engagements. The critical pitfalls in considering the application of these “other” discounts are threefold.

1. First, it is important that the valuation practitioner not duplicate value influences in other facets of the valuation and, again, in the discount. When using these discounts, consideration should be given to whether they are already reflected in the development of capitalization or discount rates, future benefit stream scenarios, market multiples or even other discounts.
2. Second, careful consideration should be given to the base to which the discount is applied, and how theoretical and empirical support for the practitioner’s opinion can best be developed and articulated in the valuation result.
3. A final important consideration in applying such discounts is recent judicial developments. For those valuation engagements that ultimately will be settled in a court venue, a thorough understanding of the appropriate court’s opinion on the additional discount is critical. Obviously, such decisions can provide important guidance and support for certain discounts in other venues, as well.

While there may be an endless number of potential discounts deemed appropriate by valuers in different engagements, those most commonly used by the business valuation community and encountered in judicial decisions include:

1. Blockage discount/market absorption
2. Key person discount
3. Restrictive agreement discount
4. Investment company discount
5. Nonvoting stock discount

Other discounts that are occasionally used in the course of a valuation engagement include:

1. Information access/reliability discount
2. Non-homogeneous assets discount

3. Lack of diversification discount
4. Small company risk discount
5. Specific company risk discount
6. Liquidation costs discount

II. OTHER TYPES OF DISCOUNTS

A. BLOCKAGE DISCOUNT

The need for a blockage discount usually arises in consideration of supply and demand influences in the publicly traded securities markets. In other words, a transaction offering a substantial block of a single entity's issued and outstanding shares may create a supply that exceeds current demand. Such an occurrence will generally impair the subject company's value because of the reduced liquidity associated with the oversupply.

The business valuator, under these circumstances, must consider a discount to adjust the value of subject shares for this reduced liquidity characteristic. The discount applied in this circumstance is generally referred to as a blockage discount.

Treasury Regulation §20.2031-2 states the following:

The size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued.

If...the block of stock is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations...

The concept of blockage is not usually applied directly in the case of closely held stocks, since there is no record of average trading volume with which to compare the size of the block. The data...on discounts for lack of marketability do, however, suggest that larger blocks tend to sell at a greater discount than smaller blocks, so the large size of a block could be a factor that influences the magnitude of the discount for lack of marketability.¹²

One recent court case that allowed one of the largest blockage discounts was the *Estate of Mellinger* (112 T.C. 26). In this case, the Tax Court deemed it appropriate to apply a 25% blockage discount (as applied by the taxpayer) to large blocks of Frederick's of Hollywood stock, which was thinly traded.

¹² Shannon Pratt, Robert Reilly and Robert Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 3rd Edition, (Burr Ridge, III: Irwin Professional Publishing, 1995), p. 324

There are several factors to consider when using a blockage discount:

1. Size of block to total shares outstanding
2. Size of block to daily trading volume
3. Volatility of stock
4. General economic and industry trends
5. Alternative stock disposition mechanisms
6. Time requirements for full market absorption of the subject block without affecting current market price
7. Special stock offerings
8. Sales of the block in smaller units over a reasonable disposition period
9. Exchange and reorganization mechanisms
10. Private placements
11. Use of an underwriting syndicate

Note: Not all larger blocks of stock require a blockage discount. The valuator must weigh all facets of the blockage effect, if any, in determining the appropriateness and size of the discount.

B. KEY PERSON DISCOUNT

Business valuers would generally consider an additional discount for a company where thin management and a strong company dependency on the efforts of a single individual for future operational and financial success would be threatened without their presence. Such a discount is generally referred to as a key person discount.

A few factors should be considered when using a key person discount:

1. Key executive's duties from both a day-to-day standpoint, as well as his or her involvement in guiding the long-term strategic course of the business
2. Key executive's reputation within the industry and the effect of that reputation on overall operational and financial results both historically and prospectively
3. Depth of overall management, experience of lower management, if any, and presence of a succession plan
4. Cost and time requirements to hire necessary replacements for key executive
5. Availability and adequacy of key person life insurance to fund such a transition, if necessary—Key person life insurance is sometimes earmarked for specific purposes beyond management transition:
 - a) Funding repurchase of company stock
 - b) Funding purchase of company utilized real property or other assets held by key person

The impact of the key person on the overall value of equity securities is often incorporated into the future benefit stream computations or the company-specific discount and/or capitalization rate development.

The courts have often recognized the impact of key persons on value via a discount. In *Estate of Paul Mitchell* (T.C. Memo 1997-461), the court recognized a 10% discount, which equated to a \$15 million reduction in value. Also in the *Furman v. Commissioner* (1998 WL 209265) the Court accepted a 10% key person discount. In *Estate of Stirton Oman*, (T.C. Memo 1987-71), a key person discount was rejected since the decedent's sons were managing the company both

before and after the father's death. In this case it also appeared that the decedent's son had been groomed for the position, and that succession planning had taken place.

C. RESTRICTIVE AGREEMENT DISCOUNT

Restrictions under various shareholder documents including buy-sell agreements, restricted stock agreements, etc. can severely limit the shareholder's ability to sell or transfer his or her stock—the impairment increases with the severity of the restriction. Value impairment due to the presence of restrictive agreements is generally incorporated into the overall discount for lack of marketability. The Courts have historically looked at these agreements as minor evidence influencing estimates of value, but seldom have they let such agreements necessarily set value.

A number of factors should be considered when reviewing stockholder's rights:

1. Income and dividend preferences
2. Liquidation preferences
3. Voting rights
4. Stock sale limitations
5. Stock value formulas
6. Preset stock price

Do not confuse a right of first refusal with a more severe restrictive agreement discount. If history shows that fair market value has been paid, pursuant to a right of first refusal, and the company's financial ability to pay in the future appears sound, such a right does not really impair value.

D. INVESTMENT COMPANY DISCOUNT

Investment companies are generally sold on the basis of underlying assets rather than future benefit streams. Such an asset approach is rooted in Revenue Ruling 59-60, which states,

the value of the stock in a closely held investment in a real estate holding company...is closely related to the value of the assets underlying the stock

An analysis of publicly traded investment real estate companies (*Partnership Profiles*) and publicly traded closed-end funds reveals that minority interests in investment companies typically sell at a discount from their respective pro rata share of the firm's net assets restated at fair market value. The application of an investment company discount would account for the shareholders' indirect ownership of these assets, and their inability to force the sale, liquidation, or merger of these assets.

Investment company discounts typically range anywhere from 10% to 60% or higher, depending on the facts and circumstances of each case. In a purely theoretical sense, this is a minority interest discount, but may include an influence from marketability.

Several court decisions address this discount. In *Estate of T. John Folks, Jr.* (T.C. Memo 1982-43), the court agreed to a 50% discount for a minority interest, plus a discount for lack of marketability. In *Estate of Albert L. Dougherty* (T.C. Memo 1990-274), the court allowed a 35% discount for nonmarketability and operating and liquidation costs. The entity was a second tier trust holding a corporation that held real property.

E. LACK OF VOTING RIGHTS DISCOUNT

In valuing minority interests, the issue of voting versus nonvoting shares must be considered. Assuming that voting shares can guide corporate policy and strategy, some difference in value must connect to a share of stock with voting rights versus one without.

That difference in value depends, to a great degree, on the size of the block being valued and the overall distribution of the ownership. If a very small percentage of outstanding shares controls the overall company, the discount for lack of control would be substantial on the balance of the minority interests. Where control is not in play, empirical studies have held the difference in value for non-controlling minority voting shares and minority nonvoting shares to be under five.

Several factors should be considered when using the lack of voting rights discount:

1. Size of block being valued
2. Distribution of stock
3. Restrictive agreements
4. Convertibility provisions of the nonvoting shares

F. ADDITIONAL DISCOUNTS

1. Information access/reliability discount
 - a) Compensates for sparse and unreliable information
2. Non-homogenous assets discount
 - a) Applicable to companies with diverse asset basis
 - b) Serves as a measure of asset underutilization
3. Lack of diversification discount
 - a) Compensates for one-product companies
4. Small company risk discount
 - a) Provides adjustment for smaller company variations on a number of fronts from larger organizations
5. Specific company risk discount
 - a) Provides adjustment for additional company-specific risk characteristics (i.e. lawsuits, customer base, single supplier, etc.)

6. Liquidation costs discount
 - a) Adjusts for cost of reducing estate assets to cash
 - b) IRS at odds with tax practitioners on this issue

III. CHAPTER SUMMARY

Keep in mind that discounts generally alter the gross value estimate in a substantial manner and, as such, require careful analysis of all pertinent facts and circumstances to support their application. Care must be exercised to avoid “doubling up” in this area as many of the factors to consider in applying various discounts often come into play in other areas of the valuation process.